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Mass.Gov Home   State Agencies   State Online Services

- DOR Home
- For Individuals and Families
- For Businesses
- For Local Officials
- For Tax Professionals

Home > Businesses > Help & Resources > Legal Library > Letter Rulings > Letter Rulings - By Year(s) > (2005-2009) Rulings >

# Letter Ruling 05-5: Qualification as a Manufacturing Corporation

June 7, 2005

You request a ruling on behalf of \*\*\*\*\* (hereinafter, “the Company”), a Delaware corporation doing business in Massachusetts. In particular, you inquire as to whether developing software and transmitting it by electronic means to a third party contractor for use in the production of storage networking host bus adaptors and embedded storage switches constitutes manufacturing activity for purposes of being deemed a manufacturing corporation entitled to apportion its taxable net income based solely upon its sales factor pursuant to G.L. c. 63, § 38(l)(2)(v).

## STATEMENT OF FACTS

The Company is a leading designer, developer and supplier of computer networking storage solutions. It is headquartered in California and has facilities in Colorado, Massachusetts and Washington. Product design and development is carried on in all four of these locations. The Company’s two main products are storage networking host bus adapters (“HBAs”) and embedded storage switches (“Switches”). Switches are sold as stand-alone “Chips” or integrated into “Switch Boxes.” The Company’s products are ultimately marketed to original equipment manufacturers, distributors and end users.

HBAs are devices that provide data processing and connectivity between a computer server and storage device. The HBA is sold in the form of a printed circuit board assembly which plugs directly into a customer’s computer system. The printed circuit board assembly consists of various electronic components, including programmable memory devices.

Switches are used in data storage devices to allow several users to share common storage devices. A Switch Box is made up of a printed circuit board assembly that contains the Chip and many other electronic devices, including programmable memory devices, fans, power supplies, and cables, all enclosed in a metal box. Switches sold in Chip form do not contain any software. Instead, the software required to make the Chip operate is installed onto other components of the customer’s computer system.

The Company designs and develops its HBAs and Switch products at its locations in the United States. The Company employs engineers, technicians and support personnel to identify and develop new products and improve existing products, including the hardware and software portion of the products. The Company’s 130 software engineers research, design, write and update all its software.

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Select an area to search

Search

The Company's HBA and Switch Boxes are fabricated by contract manufacturers located in the United States, Spain, Mexico and Malaysia. The contract manufacturers produce these items based on the Company's designs, blueprints and internally developed software. The Company develops the software and transmits it electronically to its contract manufacturers who then either embed it onto the programmable memory devices or burn it onto a compact disc. The software becomes part of the HBAs and Switch Boxes and is necessary to make these products functional.[\[1\]](#)

DISCUSSION

General Laws chapter 63, section 38(l)(2) provides that a manufacturing corporation shall apportion its taxable net income based upon one hundred percent of its sales factor rather than the percentage that results from the three factor formula set out in section 38(c). Section 38(l)(1) defines a "manufacturing corporation" as "a domestic or foreign corporation that is engaged in manufacturing. In order to be engaged in manufacturing, the corporation must be engaged, in substantial part, in transforming raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature and adapted to a new use."

As re-stated and elaborated in the Department of Revenue's Apportionment Regulation, 830 CMR 63.38.1(10)(b):

A corporation...is a section 38 manufacturer for any taxable year if (i) it is engaged in manufacturing during the taxable year and (ii) its manufacturing activity during the taxable year is substantial. A corporation that is so engaged in manufacturing and whose manufacturing activities are substantial is a section 38 manufacture [sic] for the taxable year regardless of whether, or to what extent, it conducts its manufacturing activities in Massachusetts.

Engaged in Manufacturing

You cite Commissioner of Revenue v. Houghton Mifflin Company, 423 Mass. 42 (1996), for the proposition that developing intangible content and transferring it to a third party for physical application in the manufacturing process qualifies as manufacturing activity. In Houghton Mifflin, the Supreme Judicial Court noted that the taxpayer "transforms ideas, art, information, and photographs, by application of human knowledge, intelligence, and skill, into computer discs, ready for use by independent printers, containing an immense amount of information in a highly organized form." Id. at 48. The Court found that this activity "transcends the mere manipulation of information and constitutes a substantial and integral step in the process of manufacturing books." Id. at 50. Thus, the Court concluded that the taxpayer was, in fact, engaged in manufacturing.

The Department's Manufacturing Corporations Regulation, 830 CMR 58.2.1(6), provides guidelines for determining whether a corporation may be classified as a manufacturing corporation for purposes of G.L. c. 63, §§ 38C and 42B. While these guidelines are intended to apply to classifying a corporation as engaged in manufacturing in Massachusetts, we concur that they are applicable by analogy to corporations seeking manufacturing corporation status for purposes of G.L. c. 63, § 38(l). Among the guidelines as to what constitutes manufacturing is the following:

A process that produces intangible property, either in whole or in part, to be used in a manufacturing process may constitute manufacturing. However, the process by which the intangible property is created must transcend the mere manipulation of information and must be a substantial and integral step in the manufacturing process. Moreover, the intangible property must have a physical application in the final manufacturing activity. 830 CMR 58.2.1(6)(b)8

You further posit that although in Houghton Mifflin the intangible content was transferred to the independent contractors via disc, electronic transmittal of internally developed software to a third party for reproduction also qualifies as manufacturing activity. We determine that the manner of

transfer or transmittal of the intangible property to be used in manufacturing is not crucial and, therefore, agree. As in Houghton Mifflin, the reproduction of this canned property may be outsourced to a third party, provided that the Company retains oversight and is ultimately responsible for the sale of the final product. Moreover, it is not necessary that the property outsourced be physically transferred (i.e., it may be transmitted electronically), so long as the transmitted property represents or is incorporated into the final property to be sold.

A key determination is whether the Company's transmittal of software to its contract manufacturers to be imbedded in the HBAs and Switches constitutes a substantial and integral step in the manufacturing process. Based upon the facts presented, we rule that it does. Similar to Houghton Mifflin's activities leading to the manufacture of books, the Company's activities in researching, designing, writing and updating software to be integrated into the HBAs and Switches constitute a substantial and integral step in rendering the HBAs and Switches usable products. Further, consistent with the Department's Manufacturing Corporations Regulation, the Company's software has a physical application in the final manufacturing activity.

#### Substantiality

The Department's Apportionment Regulation, 830 CMR 63.38.1(10)(b)2 provides that:

A corporation's manufacturing activity is substantial for any taxable year if the corporation meets any of the following tests:

- a. The corporation derives twenty-five percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
- b. The corporation pays twenty-five percent or more of its payroll for the taxable year to employees working in manufacturing operations and derives fifteen percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
- c. The corporation uses twenty-five percent or more of its tangible property in manufacturing during the taxable year and derives fifteen percent or more of its receipts for the taxable year from the sale of manufactured goods that the corporation manufactures;
- d. The corporation uses thirty-five percent or more of its tangible property in manufacturing during the taxable year.

With regard to the substantiality of the Company's manufacturing activities, you have indicated that 86.32% of the Company's gross receipts for its fiscal year ending June 30, 2004 were derived from the sale of HBAs, Switch Boxes and other software sold in a compact disc format. This percentage pertains to items designed and developed at all four of the Company's facilities in the United States. Assuming the validity of this percentage, the Company would meet the substantiality requirements set out in G.L. c. 63, § 38(l) and 830 CMR 63.38.1(10)(b)2. The Apportionment Regulation, at 830 CMR 63.38.1(10)(b)2, states that a corporation must derive 25% or more of its receipts for the taxable year from the sale of manufactured goods "that the corporation manufactures." Although, as previously indicated, the Company utilizes third-party contract manufacturers to ultimately fabricate the HBAs and Switches, the activities of the Company have been found to constitute a substantial and integral step in the process of manufacturing based upon the standard enunciated in the Houghton Mifflin case.

#### CONCLUSION

Based on the facts as you have presented them, the Company qualifies as a manufacturing corporation for the period at issue pursuant to the provisions of G.L. c. 63, § 38(l).

Very truly yours,

/s/Alan LeBovidge

Alan LeBovidge  
Commissioner of Revenue

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[\[1\]](#) Based upon this description, the Company's software appears to fit within the definition of "canned software" found at 830 CMR 64H.1.3(2) which defines such as "a software program held for general or repeated sale or lease, including a program developed for in-house use which is subsequently offered for sale or lease to others, and including any standard documentation or manuals designed to facilitate the use of the program by the customer."